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**CRAWFORD SCHOOL  
OF ECONOMICS AND GOVERNMENT**

# POLICY BRIEFS

## Asia's Economic Transformation: Implications for Australia

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Ligang Song  
Ross H McLeod

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ANU COLLEGE OF ASIA & THE PACIFIC

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## Asia's Economic Transformation: Implications for Australia

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### About this Policy Brief

This policy brief details recent economic developments in four of Asia's largest economies - Japan, India, China and Indonesia - and assesses the implications of these changes for Australia. Jenny Corbett looks at how economic frustrations led to political change in Japan and argues that, despite this year's devastating earthquake and tsunami, there is opportunity for continued economic growth if the Japanese government, in conjunction with industry, pursues a program of smart rebuilding and does not become mired in prolonged political disagreement. Raghbendra Jha looks at how structural changes in the Indian economy, along with changes in Indian society, have increased the rate of growth in the world's second largest country. He argues that while trade and investment relations between Australia and India are strong, there is substantial room for improvement. He highlights infrastructure and the services sector as potential expansion areas. Ligang Song sees continued benefits to Australia from China's ongoing growth in the third part of this policy brief. This rapid growth, however, will bring macroeconomic, environmental, and social challenges in China that can only be overcome through major structural reforms. Finally, Ross McLeod examines the issues confronting Indonesia's economy, including high inflation, corruption and wasteful energy use. He argues that while these present significant challenges, Indonesia's economy is still performing strongly, being one of the few countries not to have suffered a severe decline in growth as a result of the Global Financial Crisis.

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## About the authors

**Jenny Corbett** is Professor of Economics at ANU and the Executive Director of the Australia-Japan Research Centre at the Crawford School. She is also Reader in the Economy of Japan at the University of Oxford and a Research Fellow of the Centre for Economic Policy Research in London. Her research centres on current macro-economic and financial policy issues in Japan, regional financial integration and trade in financial services. She is a member of the Australia New Zealand Shadow Financial Regulatory Committee which comments on current developments in financial and monetary policy.

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**Ross H McLeod** is Associate Professor at ANU and a member of the Indonesia Project, Arndt-Corden Department of Economics, Crawford School. He is also the Editor of the Bulletin of Indonesian Economic Studies, a position he has held since 1998. He has been researching Indonesia since 1978, and has also spent many years working there. His current research focuses on the economic crisis that began in Indonesia in mid-1997, with particular emphasis on analysing its causes, how it was handled and how similar occurrences might be prevented in the future. He also has a strong interest in monetary and exchange rate policy, financial sector policies, privatisation, corruption and public sector reform in Indonesia.

# Asia's Economic Transformation

## Japan

Jenny Corbett

The rhetoric of Japan's "lost decades" is misleading. It creates an image of economic stasis over 20 years, which is far from the truth. Growth performance has been mixed but not without success. From 2001 to 2007 Japan experienced the longest period of economic expansion since WWII. In 2005 it was the fastest growing OECD economy and that growth was underpinned by domestic investment and strengthened corporate and banking performance. R & D expenditures were higher than in Germany, the US or France. Government fiscal balances were improving and deflation had ended. The global financial crisis derailed this performance but only briefly, and domestic financial structures proved resilient. By 2010 industrial production bounced back and GNP grew at 2.5 – 3.0% as an export-led recovery was boosted by stronger-than-anticipated recovery in Western advanced economies and rising capital goods demand in China. At the start of 2011 consensus forecasts were around 1.5% GDP growth for the year ahead, reflecting the dampening effect of the stronger yen and slower growth elsewhere. By most estimates the output gap was still significant so the economy was underperforming relative to potential but not in absolute terms.

Even before the March 11 earthquake important political changes had reflected voter frustration with policy failures in dealing with ongoing structural economic problems. In August 2009 the opposition party DPJ won a majority in the upper House and ousted the long-standing LDP government. A lack of confidence in government economic policy, weariness with vacillating and ineffective decision-making and a growing sense that structural reform produced regional and inter-generational inequality rather than the promised regeneration, played a key role. The new government initially promised a focus on consumers rather than producers and employment rather than fiscal rectitude but as one prime minister replaced another there appeared to be no strategy to deal with the continuing problems of declining population, growing government debt and an ever-rising yen. The Cabinet, under current Prime Minister Naoto Kan, approved a 'New Strategy for Economic Growth' in June 2010 with the goal of 3% real economic growth, overcoming deflation, and a 3% unemployment rate. There was a strong emphasis on

restoring public finances with promises to cut the ratio of primary budget deficit to nominal GDP by half from 6.4% in FY 2010 to 3.2% in FY2015 and reduce the primary budget deficit to zero in FY2020. After the DPJ loss in the Upper House election of October 2010 there was more focus on stimulus than on public finances.

To restore growth in the face of declining labour supply and lacklustre productivity growth, even a dysfunctional government could see that structural reform, harnessing trade liberalization to drive it, would be crucial. So the key elements of the growth strategy before the earthquake were accelerating EPAs/FTAs, strengthening environmental technology, and boosting tourism to stimulate the economy. The major policy debates before the earthquake were whether Japan should join the currently most promising trade liberalizing negotiations in the Asia-Pacific region, the TPP, and how to shift the opposition from the agriculture lobby by packaging liberalization with income support and safety nets for farmers. Policy announcements on both these have been promised for June but that timetable is now unlikely. This may mean a missed opportunity to combine METI's new Industrial Structure Vision with a focus on improving services sector productivity, reducing reliance on manufacturing and re-energising the structural change agenda.

The effect of the earthquake, tsunami and nuclear disaster on these longer-term structural questions is unpredictable. The short-term effects on GDP growth could be overcome within a year if normal patterns prevail but the uncertainty over power supplies and the future of the nuclear industry make this much more difficult to foresee. If smart rebuilding contributes to relocation of manufacturing, further integration into production-network trade patterns in neighbouring Asia, more flexible agriculture and a modernised services economy the prospects for a return to growth are brighter. If it results in prolonged political squabbles and a desire to recreate what was lost the prospects are less good. A modernised services economy the prospects for a return to growth are brighter. If it results in prolonged political squabbles and a desire to recreate what was lost the prospects are less good.

# Asia's Economic Transformation

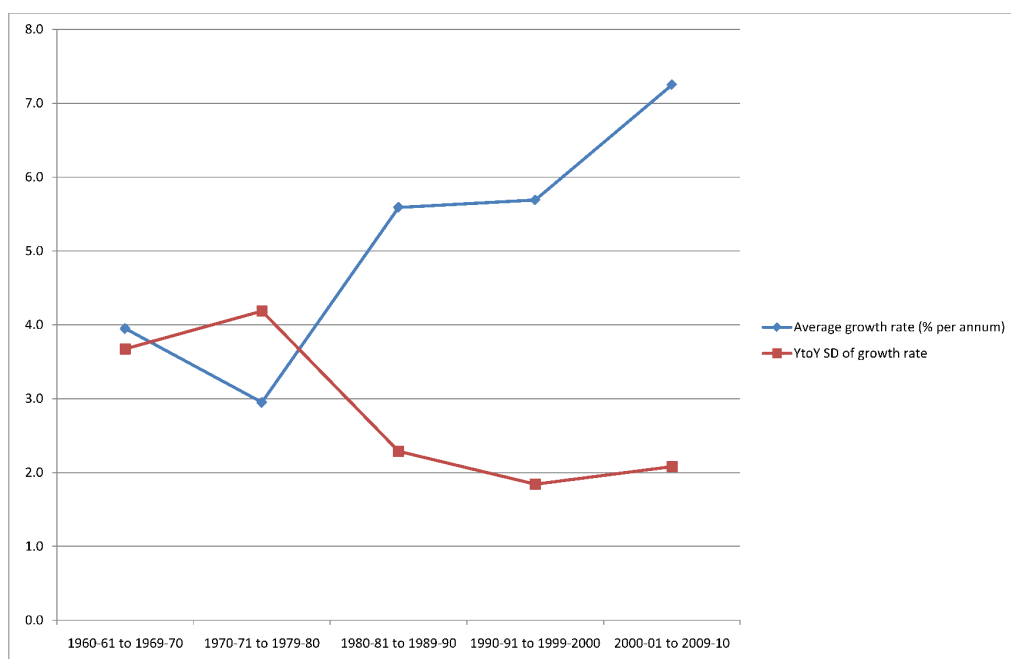
## India

Raghbendra Jha

In 2010 India's GDP in PPP terms was \$3.92 trillion. By this reckoning India was the fourth largest economy in the world after the US, China and Japan. Citi Investment Research and Analysis estimates that in a decade India will be the third largest economy. Between 2000-01 and 2007-08 India's real GDP growth averaged 7.3 per cent per annum. Growth rates have recently been around 9 per cent and, sometimes in excess of 9 per cent except for the period since 2008-09. In that year GDP growth fell to 6.7 per cent in the face of the GFC. GDP growth rate picked up the very next year when it was 8 per cent. In 2010-11 real GDP growth is estimated to be 8.6 per cent and in 2011-12 is estimated to return to 9 per cent. With a population growth rate of about 1.7 per cent per annum (according to the latest Census of India (2011)) real GDP growth per capita has been in excess of 7 per cent per annum for several years. At this rate real GDP per capita will double in about 10 years. Since the 1970s average decadal growth rates have gone up even as the standard deviation of year to year growth has gone down (Figure 1).

The structure of India's GDP has undergone immense transformation in the face of such rapid economic growth and has in, turn, contributed to it. During the decade 1961-70 agricultural value added as a percentage of GDP was 42.5 per cent. Corresponding magnitudes for industry, manufacturing and services were, respectively, 20.3 per cent, 14.3 per cent and 37.2 per cent. In 2008 agriculture contributed 17.6 per cent of GDP whereas the contributions of industry, manufacturing, and services were respectively 29 per cent, 16 per cent and 53.4 per cent, respectively. This is an indicator both of India's potential for further economic growth as well as that of a fundamental problem facing the Indian economy – how does one sector (agriculture) that contributes less than 18 per cent of GDP support more than 60 per cent of India's population? Within manufacturing India has increasingly specialised in higher value added manufacturing. In a growth accounting sense capital, labour and productivity growth have all contributed to enhanced rates of economic growth in India. Savings rates have risen to about 34 per cent and investment to about 36 per cent, particularly since the 1990s, from very low levels in earlier decades.

Figure 1 Average decadal growth rates and standard deviations of year to year



Source: Reserve Bank of India: Handbook of Statistics on the Indian Economy

# Asia's Economic Transformation

There is a very strong “demographic dividend” as the median age of the Indian population hovers around 25, indicating that India is home to more than 600 million people below the age of 25. Further, this labor force is becoming better trained (literacy rates have risen to 74 per cent in the 2011 census). There is evidence that Total Factor Productivity in the production of aggregate GDP, and in the Manufacturing and Services Sector have each gone up, particularly post 1994. Agricultural productivity has not grown very fast. Openness to trade and investment went up sharply, particularly during the period 2002-07. Even after the GFC India continued its policy of trade liberalisation, with average manufacturing sector tariffs now down to 12 per cent or less.

All these factors imply that economic growth rates in India will stay high and, given the increasing demographic dividend, may even accelerate. High rates of economic growth in India imply that there has been substantial poverty reduction. But the elasticity of poverty reduction with respect to economic growth is lower in India than in many Asian countries, essentially because of the structure of economic growth. This implies that inequality has increased, but is still well below that of many emerging economies.

Australia-India trade and investment relations are strong but well below potential. Bi-directional trade is heavily in favour of Australia. Australian exports to India are mainly in the resource area and there are some service exports. Indian exports to Australia are largely in the areas of Information Technology, pearls and gems, some electronic equipment and some service imports. FDI in each direction was around A\$3 billion in 2008-09.

There is substantial room for expansion of both trade and investment. India is expected to invest more than US \$1 trillion in infrastructure in the near future. There is substantial room for Australian investment and expertise in this area. Other areas of possible economic collaboration include food processing, educational institutions in India and the use of service sector expertise to enhance manufacturing sector growth, an area in which India has done very well. Australia could benefit from India's expertise in this area. The Indian economy is likely to be a very strong engine for economic growth not just in the region, but globally as well.



# Asia's Economic Transformation

## China

Ligang Song

China's economic transformation since the late 1970s is now recognised as one of the most significant social changes in human history. Within just three decades, China has transformed itself from a centrally-planned, closed economy to a market-oriented open economy, delivering rapid and sustained economic growth along the way. The dynamics unleashed by the reform, open policies and institutional changes included enormous entrepreneurial energy and continuous capital accumulation, labour migration, productivity gains, trade and income growth on a scale that the world has never seen before. The Chinese economy grew at an average rate of over 9 per cent per annum over the period 1978-2010. China's total GDP, industrial output, foreign trade, and importantly its per capita income increased in real terms by factors of 16, 27, 124 and 12 respectively over this period. As a result, the incidence, depth and severity of poverty have declined dramatically. China is now the second largest economy in the world with its GDP accounting for about 10 per cent of the world total.

China is entering a new period in which its pattern of growth will be dictated not only by those fundamental forces that have been working in the past, but by the strategies that China has been compelled to adopt at this stage of its development. China's rapid growth brings about significant macroeconomic, environmental, and social challenges that have their origin in its pattern of growth as well as in the changing internal and external environment in which growth takes place. The major problems China faces both internally and externally, now and in the foreseeable future, are structural in nature. At the core are two main tasks of rebalancing the economic structure both internally and externally, and sustaining long-term growth. The latter task consists of the imperatives of achieving low carbon as well as more equitable growth in the next phase of China's industrialisation and development. A key for China is to alter its mode of economic growth from relying primarily on the inputs of factors of production to the improvement of productivity. To achieve the task, China's key institutions need to be reformed to accommodate the rapid technological, structural, social and distributional changes. Maintaining a relatively open, multilateral political, trading and financial system provides an important institutional basis on which the required structural changes take place, the expansion of

international trade continues to be a positive-sum rather than a zero-sum game, and the global common goals such as financial integration, poverty reduction, climate change and regional and international security can be achieved with success. China is expected to play a more important role in reforming and strengthening such a system.

To reflect the adjustment in its growth strategy, China has set a relatively low growth target of 7 per cent per annum in the 12th Five-Year plan (2011-2015). Other key targets for this period include: increasing the urbanisation rate to 51.5 per cent (up by 4 percentage points), lifting the service sector's share in GDP to 47 per cent (up by 4 percentage points), creating 45 million new jobs in urban areas, increasing R&D expenditure in GDP to 2.2 per cent, and cutting energy consumption per unit of GDP by 16 per cent and carbon emissions per unit of GDP by 17 per cent. Australia will continue to benefit from these developments in China.

# Asia's Economic Transformation

## Indonesia

Ross H McLeod

Indonesia was one of very few countries not to suffer a severe decline in growth as a result of the Global Financial Crisis. Even at its lowest point in mid-2009 the GDP growth rate remained above 4% p.a., recovering to a surprisingly high 6.9% by the end of 2010 – with growth being driven primarily by investment spending, indicating a high level of business confidence. Inflation has been quite steady for the last six months at close to 7% p.a., which is a little above the target range. This is a disappointing outcome rather than a major problem, and reflects the central bank's reluctance to allow the rupiah to appreciate. In response to surging food prices the government has temporarily removed tariffs on rice, wheat and soybeans, and ordered increased rice imports.

A severe fiscal problem has been apparent over the last several years – not in the usual form of unsustainable deficits, but as a consequence of enormous subsidies to the consumption of energy, both fuel and electricity. These ongoing subsidies do not threaten macroeconomic stability but, rather, encourage the wasteful use of energy, frittering away a large proportion of the value of Indonesia's abundant hydrocarbon resources – oil, gas and coal. The main beneficiaries are the relatively wealthy classes, since they consume much more energy than the poor. Although the government is aware of the problem, its frequently professed intention to reduce the subsidies has been repeatedly postponed. Thus the national budget devotes many billions of dollars to energy subsidies instead of using these funds to create new infrastructure and to provide better and more extensive education and health services.

The composition of exports has altered quite dramatically over the last two decades, albeit in unanticipated directions. The high hopes that had earlier been held for labour-intensive exports such as textiles, clothing and footwear have not come to fruition. Rather, the expansion of exports has been dominated by coal and palm oil. The country shares of exports have also undergone significant change, reflecting the growing relative importance of Asia to the global economy. Exports to countries such as Malaysia, India and China have been expanding rapidly, while Indonesia's older export markets – the US, Japan and Europe – are being steadily pushed

to the background.

Indonesia's banking system virtually collapsed in the late 1990s during the Asian Financial Crisis, at enormous cost to taxpayers. By contrast, it came through the Global Financial Crisis almost unscathed, except for the failure of a single, relatively small bank. This episode, which cost the government about \$700 million, reminded policymakers of a forgotten decision of about 11 years ago to establish a single authority to supervise the entire financial sector. There were extensive discussions of a draft law along these lines in 2010, but as yet it has not been possible to resolve certain issues. This is fortunate, because the draft law, if enacted, would result in a wasteful and confusing duplication of the role of bank supervision in the planned new authority. In any case, there is little to suggest any clear understanding on the part of policymakers as to exactly what establishing the new authority is supposed to achieve.

The current dynamism of the Indonesian economy would appear to spring mainly from the private, rather than the public, sector. There are frequent complaints about the government's continuing failure to invest adequately in infrastructure, while proper management of public sector infrastructure has been largely overlooked. The president's proposal for a new capital city as a solution to the horrendous shortcomings of Jakarta is unhelpful, because it avoids the fundamental question as to why Jakarta and other large cities perform their many and diverse functions so poorly. Well functioning cities are crucial to modernisation of the economy, and are also important for poverty reduction. City governments could greatly improve their performance by adopting a strategy of financial self-reliance: requiring the users of the services they provide to pay for them, rather than relying on central government handouts to cover costs. Thus far, however, there appears to be little support for such a strategy.

Notwithstanding the president's heavy emphasis on eliminating corruption, there is little concrete evidence to suggest that much progress has been made over the last six or seven years. The general public is becoming increasingly concerned about the gap between policy rhetoric and action in this field. A strong contributor to

this recently has been a long-running corruption saga involving a relatively junior tax official, whose activities have helped confirm the public's worst fears about the ineffectiveness of the anti-corruption campaign. This case has made it clear not only that corruption still infects the ministry of finance, but also that it remains rampant in the courts, the police, the prison system and the immigration office. Claims of progress in this and other fields usually are typically grossly overstated, and opinion polls suggest that they have become unconvincing to voters. Genuine progress in minimising corruption is unlikely to occur in the absence of radical change in human resource management practices, including abandonment of promotion by seniority, opening up the public sector to recruitment from outside, and much more closely aligning public sector levels of remuneration with the private sector.

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